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# Tax treatment of bad and doubtful debts

Lenders may face increasing difficulty in recovering debts in the current business conditions. The deterioration of the prospects of recovery has tax implications. These implications depend on a number of factors. This article provides a brief overview of the tax considerations that are relevant in respect of bad or doubtful debts.

In the current business conditions lenders increasingly face the prospect of not being able to fully recover debts. These debts may include trade debts, for example, trade receivables, but also longer-term debts. This article provides an overview of the relevant tax considerations in respect of these debts.

**Trade debts**

Trade debts arise from trading transactions. The amounts that accrued in terms of the underlying transactions, which reflect in the balance of the debt, were taxed as income. Depending on the nature of the transaction, it may have attracted VAT.

The Income Tax Act ('the ITA') makes provision for a range of treatments as the prospects of recoverability deteriorate. When the debt becomes doubtful, the lender is entitled to deduct an allowance. If the debt ultimately becomes bad, the lender is entitled to deduct the amount that became bad. The allowance or deduction effectively reduce the amount on which the lender is liable for tax on the underlying income. Whether a debt is doubtful or bad depends on the facts of the specific case.

The treatment of doubtful debts for income tax purposes has been revised in recent years.

If a taxpayer applies IFRS 9 *Financial Instruments* ('IFRS 9') to account for the debt in its financial statements, the allowance for tax purposes is linked to the impairment loss allowance recognised for accounting purposes. IFRS 9 requires that lenders apply a forward-looking approach to impair loans to reflect expected credit losses ('the ECL model'). The impairment loss allowance should generally reflect the 12-month expected credit losses in respect of a loan. A taxpayer may deduct 25% of this impairment loss allowance for tax purposes. If, however, the credit risk associated with a loan has increased significantly since origination (i.e. prospects of recoverability have deteriorated), the ECL model requires that the lender recognise the lifetime expected credit losses in respect of that loan. A taxpayer is entitled to deduct 40% of an impairment loss allowance for tax purposes where the loss allowance reflects lifetime expected credit losses. IFRS 9 contains specific rules for loans that are credit-impaired at origination. It also provides practical expedients. These rules and expedients would affect the tax allowances.

Taxpayers that do not apply IFRS 9, for example, taxpayers who apply IFRS for SME's, must determine their doubtful debt allowance on the basis of the age of the debt. If the debt is 120 days or more in arrears, the taxpayer may claim 40% of the debt as doubtful. If the debt is 60 days or more in arrears, the doubtful debt allowance is calculated at 25%.

Taxpayers may apply to SARS for a directive to claim a greater allowance in respect of doubtful debts.

The Value Added Tax Act does not cater for the same continuum of treatments as the ITA. A vendor is generally only allowed to deduct input tax when it has written off the consideration that has become irrecoverable.

**Non-trade debts**

These debts refer to loans advanced by one party to another, other than as part of a trading transaction. The transaction that gave rise to the capital balance of the loan would not have affected the lender's income. If the balance includes accrued interest, this amount would have been taxed as income.

The tax treatment of doubtful or irrecoverable interest is similar to that of trade debts.

The tax treatment of the capital balance of the debt is more complex. The lender should determine whether it carries on a money-lending business to establish if the debt, and any loss if it becomes irrecoverable, is of a capital nature or not. If the debt is of a capital nature, a capital loss arises when the lender disposes of the right to claim payment. In the case of related party loans, the lender's entitlement to this capital loss is dependent on the borrower's tax implications for the borrower.